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SIPDIS

TREASURY FOR OASIA - DAS LEE AND FPARODI
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E.O. 12958: DECL: 10/26/2014
TAGS: EFIN ECON EINV PGOV PREL BR
SUBJECT: BRAZIL AND THE IMF: IS THE DANCE OVER?

REF: A. BRASILIA 2447

¶B. BRASILIA 2051

Classified By: Economic Counselor Bruce Williamson, Reasons 1.4 (b) and (d).

¶1. (SBU) Summary: The GOB economic braintrust is currently debating whether to follow up Brazil's current precautionary IMF Standby Agreement (SBA) when it expires in March 2005 with another IMF program. Based on the country's fundamentals, there appears to be little need for a follow-on program, as all expectations are that Brazil will not require balance-of-payments (BOP) support in 2005. Many private analysts believe that the financial markets would look even more favorably upon Brazil if it were to graduate from IMF tutelage and maintain its responsible macroeconomic policies. But, with the memory of contagion from the Asian and Russian financial crises still fresh, not to mention the 2002 crisis of confidence sparked by Lula's election, the GoB would like some form of insurance against unexpected shocks. It has been pushing for IMF creation of a new contingency line of credit. Brazil, however, has not convinced a majority of the IMF Board to support the idea. Absent such a line of credit and given the positive economic outlook, the GoB seems disinclined to seek a follow-on SBA or other formal IMF monitoring for 2005. While the GoB would face a political conundrum should economic winds shift and force it to seek a Fund program in the election year of 2006, Lula's proven economic pragmatism suggests he would bite the bullet in that eventuality. End Summary.

Little Economic Rationale

¶2. (SBU) Visiting Regional Treasury Representative and Emboff discussed the GoB's dance with the IMF over a follow-on to Brazil's current, precautionary, exceptional-access SBA during a series of conversations October 8-15 with government officials, private sector representatives, and IMF Resident Representative Max Alier (please protect). Central Bank director for Economic Policy Afonso Bevilaqua pointed out that, judged solely on the economic merits, there is little case for a follow-on agreement. Even using the Central Bank's conservative estimates, Brazil in 2005 should enjoy another BoP surplus, of about $10 billion. (Note: private sector estimates are as high as $15 billion.) This strong expected performance undermines the traditional BOP-support rationale for an IMF program. Bevilaqua further argued that Brazil would build more market confidence by "graduating" from its IMF agreement while continuing to pursue responsible economic policies.

Potential Benefits of Graduation

¶3. (SBU) The private sector, according to Nilson Teixeira of CSFB, has already adjusted to the reality of the Lula government's responsible policy agenda. Given the lack of need for BOP support, he judged an IMF program "irrelevant." Banco Pactual's Guilherme Bacha, by contrast, felt that graduating from the IMF program and continuing the same policies would significantly reduce Brazil's country risk. Bacha nevertheless did not expect that the market would react negatively to negotiation of a new program. Former Central Bank President Arminio Fraga, now with Gavea Investments, likewise argued that Brazil would gain more in the market's eyes from pursuing responsible policies without IMF tutelage.

GoB Wants Insurance

¶4. (SBU) While the GoB,s official line is that there is no need to decide about a follow-on program before March 2005, when the current program expires, the GoB appears to be weighing two alternatives: either no program (so-called graduation) or a new type of contingent facility. For the GOB, ideally, a new contingent line for "good performers"

would combine large, automatic access to IMF resources in a crisis with minimal conditionality. Finance Ministry International Secretary Luiz Pereira observed that a new line of credit for countries with good policy records would mitigate risks of contagion and other external shocks, although such a facility would need a decent level of automatically-available resources to be credible with the market. He believed the negotiation of an SBA would be too slow in a crisis, and that this made the case for a facility that granted quick access, followed up by renewed IMF monitoring once it was activated. Pereira acknowledged it might be tricky to get the level of eligibility criteria right: too little risked moral hazard, while too much risked a repetition of the experience of the now-defunct Contingency Credit Line (CCL), which was never used. Pereira claimed "sympathy" from France and Russia for Brazil's position that this sort of facility should be part of the international financial architecture. He further stated there would be "little demand" for a policy-monitoring program that did not carry access to fund resources, implying the GoB would opt for no program at all absent the creation of a new contingent line. Treasury Secretary Levy added that the latest proposal from IMF staff outlining how such a new line of credit would work was not what the GoB had envisioned and unlikely to prove effective.

¶5. (U) Underlying Pereira's comments is Brazil's experience with international financial markets since 1998, when contagion from the Asian financial crisis forced it to seek an IMF SBA. Brazil has been on SBAs since then, and these facilities have helped it deal with financial turmoil after the Russian financial crisis and the 2002 crisis of confidence sparked by uncertainty over the policy course that then-probable presidential election winner Lula da Silva would implement. The $30 billion 2002 SBA was the IMF's single largest program, and granted Brazil exceptional access to IMF financing. (Note: Exceptional access carries an expectation of more intensive post-program monitoring.)

ResRep: GoB Bluffing

¶6. (C) IMF ResRep Alier called the GoB's new-facility-or-nothing position a "bluff." The GoB's real problem, he argued, is how to deal with the possibility that economic circumstances would require it to seek IMF financing during the election year of 2006. It would be politically problematic for the Lula administration to "kiss the Fund good-bye" in 2005 and then be forced to seek an IMF program in 2006. The GoB, he said, is still weighing that potential political loss against the (less theoretical) gains of graduating from the current SBA in 2005. Alier argued that in the absence of an IMF program, the GoB should take the step of releasing the IMF staff reports generated during routine monitoring visits next year as a way to reassure the markets. The GoB has always elected to keep IMF staff reports confidential.

¶7. (C) Addressing the specifics of Brazil's arguments for a new contingent line with high levels of automatic access, Alier stated that the Lula Administration financial team, while tough negotiators, always fulfilled their commitments. This made their case for a new line of credit with large, automatic access to IMF resources more credible. From the institutional point of view, however, it made little sense for the Fund to create a new facility tailored to the current reality of one IMF client. Moreover, he added, there was no guarantee that future GoBs would be as reliable as the current one.

Comment

¶8. (C) The politics of a follow-on program are doubtless more complex than the economics. It seems a bit hasty, however, to dismiss the GoB's current all-or-nothing position on a follow-on IMF program as a bluff. Given the low probability that the IMF Board will create a new contingent facility per the GoB,s wishes, the GoB's real choices are between graduation, a follow-on, precautionary SBA or a staff-monitored program. This last option is unpalatable as it combines all of the political drawbacks of formal IMF policy monitoring with a complete lack of access to IMF financing. With regard to an SBA, the GoB has little to gain with the markets at this juncture for signing on to a program unwarranted by the economic realities. It would further face the downside of potentially being lumped in with poor-performing countries that require prolonged access to Fund resources. That leaves graduation as the GoB's most likely choice, and with it the opportunity for the GoB to better establish its policy credentials with the market. Many in the market are also of the view that Brazil has an implicit contingency line from the IMF, as long as it pursues its current policy mix. Alier has a point that the GoB would pay a political price for graduating in 2005 if a reversal of economic fortunes forced it to seek another IMF program in

2006, when Lula would be running for reelection. But, Lula's pragmatism and consistent willingness to make tough economic decisions and justify them with the electorate mitigates this concern.

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